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ABSTRACT

This document addresses two separate, though related aspects of the operation of the Guaranteed Student Loan Program (GSLP): (1) the mechanism for setting the special rate allowance (SRA); and (2) the effect of the operating requirements of the program on lender servicing costs. The study develops recommendations for improving both aspects of the program to ensure continuing lender interest in making funds available to eligible students. To develop lender-related data to support the analysis, 16 institutions were surveyed to establish: (1) attitudes toward the program; (2) profitability objectives and expectations; (3) practices for determining the amount of GSL funds made available; (4) operating policies and practices; (5) profitability measurement and comparison criteria; (5) cost of obtaining lendable funds; and (6) costs of operating under the GSL program. Of the institutions either surveyed or for which data were obtained, 13 were lenders. The remaining three contributors were servicing firms. (Author)

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ANALYSIS OF STUDENT LOAN SPECIAL RATE ALLOWANCES AND SERVICING COSTS

PREPARED FOR

DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE
U.S. OFFICE OF EDUCATION
WASHINGTON, D.C.

PREPARED BY

TECHNOLOGY MANAGEMENT INCORPORATED
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1. INTRODUCTION AND SUMMARY

1.1 Background and Study Objectives

This study addresses two separate, though related, aspects of the operation of the Guaranteed Student Loan Program (GSLP):

- the mechanism for setting the special rate allowance (SRA); and
- the effect of the operating requirements of the program on lender servicing costs.

The objective of the study was to develop recommendations for improving both aspects of the program so as to ensure continuing lender interest in making funds available to eligible students.

Special Rate Allowance

At present, the special rate allowance in the GSLP is determined quarterly by the Treasury Department and DHEW based upon judgments regarding current market conditions and other factors. The allowance is also limited by statute to three percent. This may have the effect, especially in market conditions where interest rates are high, of making student loans unattractive to potential lenders when compared to alternative investment opportunities. Additional uncertainty on the part of lenders regarding what decisions may be made in the future concerning the special allowance may also adversely affect availability of funds to student borrowers.

The objective of the first task comprising the study was to explore the feasibility of having the amount of the special allowance determined through reference to a money market indicator or index. Use of such a "visible" index would have the potential effect of making the amount of the special allowance more certain and of having the allowance track closely the market conditions which could affect the relative attractiveness of student loans as an investment opportunity.

Operating Costs

Many lenders have claimed in the past that characteristics of student loans and the administrative requirements placed upon lenders by the Office of Education (OE) have made these loans exceptionally costly to service. To the extent that such claims may be true, especially in terms of high interest rates in money markets, this factor could also have a significant bearing on a lender's decision to make student loan funds available.

The objective of the second study task was to make estimates of the cost to lenders of servicing student loans. The results of this task could have significant bearing on the level of special allowance which might be chosen and might indicate ways in which OE could change lenders' administration requirements to reduce such costs.

1.2 Study Approach

To develop lender-related data to support the analysis, 16 institutions were surveyed to establish:

- attitudes toward the program;
- profitability objectives and expectations;
- practices for determining the amount of GSL funds made available;
- operating policies and practices;
- profitability measurement and comparison criteria;
- cost of obtaining lendable funds; and
- costs of operating under the GSL program.

Of the institutions either surveyed or for which data were obtained, 13 were lenders--nine commercial banks, two savings banks, and two savings and loan associations. The remaining three contributors were servicing firms.

To supplement the data provided by the surveyed institutions, additional information was obtained from:

- unit cost analyses of commercial banks published by the Federal Reserve for 1972; and

- compilation of money market rates and lender cost of funds from the Department of Treasury, the Federal Home Loan Bank Board, and the Federal Reserve Bank of New York.

1.3 Findings and Recommendations Regarding the Special Rate Allowance

Based on the interviews conducted with participating lenders--generally the officer with profit center management responsibility for consumer loans--the following conclusions affecting the special rate allowance emerged:

- Student loans have been marginally profitable, on average, for commercial banks since 1970. They have clearly been unprofitable for a number of institutions with higher-than-average cost servicing operations. As compared to consumer loans, student loans have been considerably less profitable than other consumer loans since 1970 primarily due to lower revenues. Higher operating costs are a lesser factor in accounting for lower comparative GSL profitability.

- Most banks have been participating in the student loan program out of a sense of social responsibility, despite the perceived unprofitability and aggravation of government imposed procedures.

- Although the banks in larger cities have, by and large, not restricted the funds made available for student loans, many smaller commercial banks and thrift institutions have. Increasingly, a bottom line justification will be demanded by all institutions as a condition for unrestricted participation.

- The particular level or expectations of the special rate allowance in the past has not really affected the banks' participation.

- The uncertainty of the amount of the SRA, as determined on a quarter-to-quarter basis, makes a lender's profit planning difficult, if not impossible, for loans booked for terms approaching ten years.

- The profitability of student loans does not have to be comparable with other consumer lending instruments to ensure that sufficient funds are made available by lending institutions. Banks must be convinced, however, that:

    - the student loan program will at least break even or return some minimum profit margin on a continuing basis;

    - operating procedures will become more efficient and less alien to their other consumer lending operations, with a reduction in the current aggravation factor; and

    - a greater "integrity in lending" can be achieved with student loans.

- The suggestion of a money market related index as a basis for determining the SRA met with uniform approval. Assuming the index would be set in a way that maintained a consistent and reasonable spread over the cost of funds, the certainty of knowing the basis for student loan revenue determination would go a long way toward justifying the student loan program on a profitability basis.

From these findings, together with the analysis (described in Section 2) of cost-of-funds and money market instrument data, TMI offers the following recommendations for setting the special rate allowance:

- Future special rate allowance for student loans should be paid at the end of each quarter based on an index for which the rate source is the discount yield of new 3-month Treasury Bill issues, as announced

by the Federal Reserve Bank of New York, each week, and averaged over all weekly auctions included in the quarter just completed.

- At the end of each quarter, the special rate allowance for the quarter just completed should be set at:

  Average Three-Month T-Bill Rate - 4%

  and constrained to be a minimum of zero percent (when the T-Bill rate is less than 4%) and a maximum of 4% (when the T-Bill rate is more than 8%). Such an index would provide a gross revenue to lenders ranging from 7% to 11% per annum on dollars outstanding.

- The adequacy of this index should be reviewed every one to two years and adjusted as needed to account for any changes in the relationship of servicing costs as a percent of outstandings or in the spread between revenue and cost of funds.

The recommended index would have maintained an adequate and reasonably constant spread over the cost of funds since 1970 and would have increased SRA payments by only $19 million, or 16%, from the beginning of calendar 1970 through the first quarter of 1974.

1.4 Findings and Recommendations Regarding Student Loan Operations

Based on the lender and servicing firm surveys, the following general observations can be made about operating practices for the student loan program:

- Extensive branch processing of student loan applications and "booked" accounts is generally avoided because of higher costs, compared to those of a centralized processing operation.

- Larger institutions now tend to centralize their student loan processing into activities dedicated to these instruments. Mid-size institutions, except perhaps for thrift institutions, tend to process student loans in their consumer loan departments mixed in with other installment loans. Small institutions, as well as thrift institutions, tend to perform student loan processing in their branches.

- Few lenders--large or small--have considered or have been able to cost-justify the use of outside servicing firms for their GSL portfolios. Other lenders--also large and small-- have embraced the concept. High conversion costs for existing loans is a major drawback for a long-involved lender to use an outside service.

- ADP approaches to support GSL operations have largely been to modify existing personal or commercial loan systems and to "mix" in student loans with the rest of the portfolio. Few lenders have developed ADP system specialized for student loan processing requirements.

- Lenders with lowest operating costs tend to have specialized student loan ADP systems. Lenders with the highest costs of operation tend to have "split" manual and modified personal loan systems.

- Many high-cost lenders have found it difficult to cost-justify the investment in effective and efficient ADP systems specialized for student loan requirements because of low volumes (and low total savings potential).

Making cost comparisons among lenders is difficult because of:

- lack of or different bases for documentation of servicing costs;

- discretionary differences in student loan operations that reflect philosophy and attitude rather than OE-imposed requirements; and

- cost structures that are "locked in" for certain institutions but not for others.

Within the limitations imposed by these difficulties, it appears that:

- efficient lenders can achieve cost levels approaching that of servicing firms. Lenders that centralize and specialize student loan operations and develop efficient, specialized student loan systems are more likely to do so.

- higher costs tend to be associated with branch processing, manual operations, or unsuitable systems.

- lenders can operate their student loan portfolios at costs comparable to other consumer loans--either their own or the FED reported consumer loan average.

- in comparison to consumer loans, student loan account maintenance costs are lower; acquisition costs are higher.

The acquisition cycle represents the largest potential for lender cost reduction. It also constitutes the greatest opportunity for reducing lender dissatisfaction with doing business under the program. Acquisition costs for student loans are one-and-a-half to three times that of consumer loans because:

- there is more interaction with the borrower;

- there are two acquisitions per loan; and

- there is a complicated origination cycle involving multiple forms and several parties.

The complications of the origination cycle fail to recognize that 50 - 75% of current borrowers are repeat GSL customers at the same institution. Yet, from the processing standpoint, all must be treated alike, unlike the "streamlined" or "short-form" procedures most lenders use for repeat consumer loan customers (also 50 - 75% of their application traffic).

Lenders have recommended that the following changes be incorporated in GSL operating requirements:

- multiple-purpose forms for loan origination consolidating on a single form the information (often redundant) now required on several forms.

- particularly for large institutions, the elimination of guarantee filling before disbursement in favor (as is the case for FHA Title I loans) of filing after-the-fact.

- a "streamlined" acquisition cycle for repeat borrowers at the same institution.

- provision for payment of the insurance fee coincident with the submission of the lender manifest.

- elimination of the separate accountability requirement for each disbursement.

Other changes in the management of the program are also suggested:

- Apply all changes to the legal, operating, procedural, or documentary requirements of the program retroactively to loans outstanding from prior years. Program distinctions between loans granted during different years proliferate the requirements that must be met by lenders.

- Announce program changes well before the peak processing session for new loans. Lenders find it particularly difficult to integrate revised program requirements into their operations during the July-September high-volume period.

- Make claims payments on defaulted loans faster and/or pay interest until such payments are made. FISL lenders, in particular, complained about foregoing interest during long (9 to 12 months) claims settlement cycles.

- Have the U.S. Government take a more aggressive and visible role in collection of delinquent and defaulted accounts. Lenders believe that active government participation in collection will significantly reduce

defaults among a mobile population with "non-traditional" attitudes toward borrower obligations to repay.

Several ideas relating to more basic revisions to the program were tested for lender reaction. Based on this reaction, TMI further recommends that:

- direct collection of student interest payments during the in-school period not be imposed on lenders. Lender responses to this suggested program change were almost uniformly and highly negative. Interest deferral while in school is far more preferable.

- a serious investigation be made into the use of a form of revolving credit as a borrowing vehicle for students rather than the present multiplicity of installment loans. From the lender standpoint, revolving credit instruments offer substantial operating savings, especially compared to the typical succession of installment loans. For the government, there could be reduced cost in interest subsidies and special rate allowances. The vast majority of lenders saw merit in the concept, subject to a suitable resolution of operating details.

2. SPECIAL RATE ALLOWANCE INDEX

2.1 Profitability of GSL as Perceived by Lending Institutions

Of the 16 banks interviewed during the study, half did not have useful cost or profitability data available by product line. However, whether or not good cost data was available, student loans were perceived to be unprofitable by most lending institutions.

Based on the cost data available to this study, student loans would have been profitable to commercial banks in 10 of 17 quarters from 1970 to 1974. This assumes that each bank's servicing cost would have equalled the average for reasonably efficient banks, which was 1.65 percent of outstandings, and that the cost of funds is defined as an average cost of all bought funds including:

- savings deposits;
- time deposits;
- borrowed funds; and
- Eurodollar deposits.

There is considerable disparity among commercial banks as to the cost of funds definition appropriate for evaluating the profitability of consumer loans in general. It will naturally vary due to differences in liability structure among lending institutions. In using the average cost of bought funds for a representative city bank that is heavily dependent on bought funds (as opposed to demand and no-notice savings deposits), we have used a measure similar to that employed by consumer lending management to evaluate past profitability.

It is the consumer lending management who are responsible for student loans in commercial banks. Student loans are compared with and must compete with other consumer lending instruments, i.e., personal unsecured loans, property improvement loans, auto loans, etc., for limited funds in times of tight money.

Although the servicing or operating expenses of consumer loans are more a function of the number of loans and their terms than the dollars outstanding, it is possible to evaluate these costs on the basis of a percentage of outstandings. The average student loan amount appears to be fairly constant from bank to bank, and total servicing costs for a loan portfolio exhibit a percentage relationship to dollars outstanding.

This relationship may change from time to time as average loan sizes and servicing costs change, but there are so many other factors affecting how these costs are measured or allocated, a precise functional cost model is not warranted for purposes of a special rate allowance index.

The following definitions will be used in evaluating consumer loan profitability:

Revenue = SRA + 7% (% per year on Outstandings)

Cost of Funds = Av Cost of Bought Funds (% per year on Outstandings)

Spread = Revenue - Cost of Funds

Servicing Costs:

Operating Expenses = % per year on Outstandings
Bad Debt Cost = Losses as % per year on Outstandings

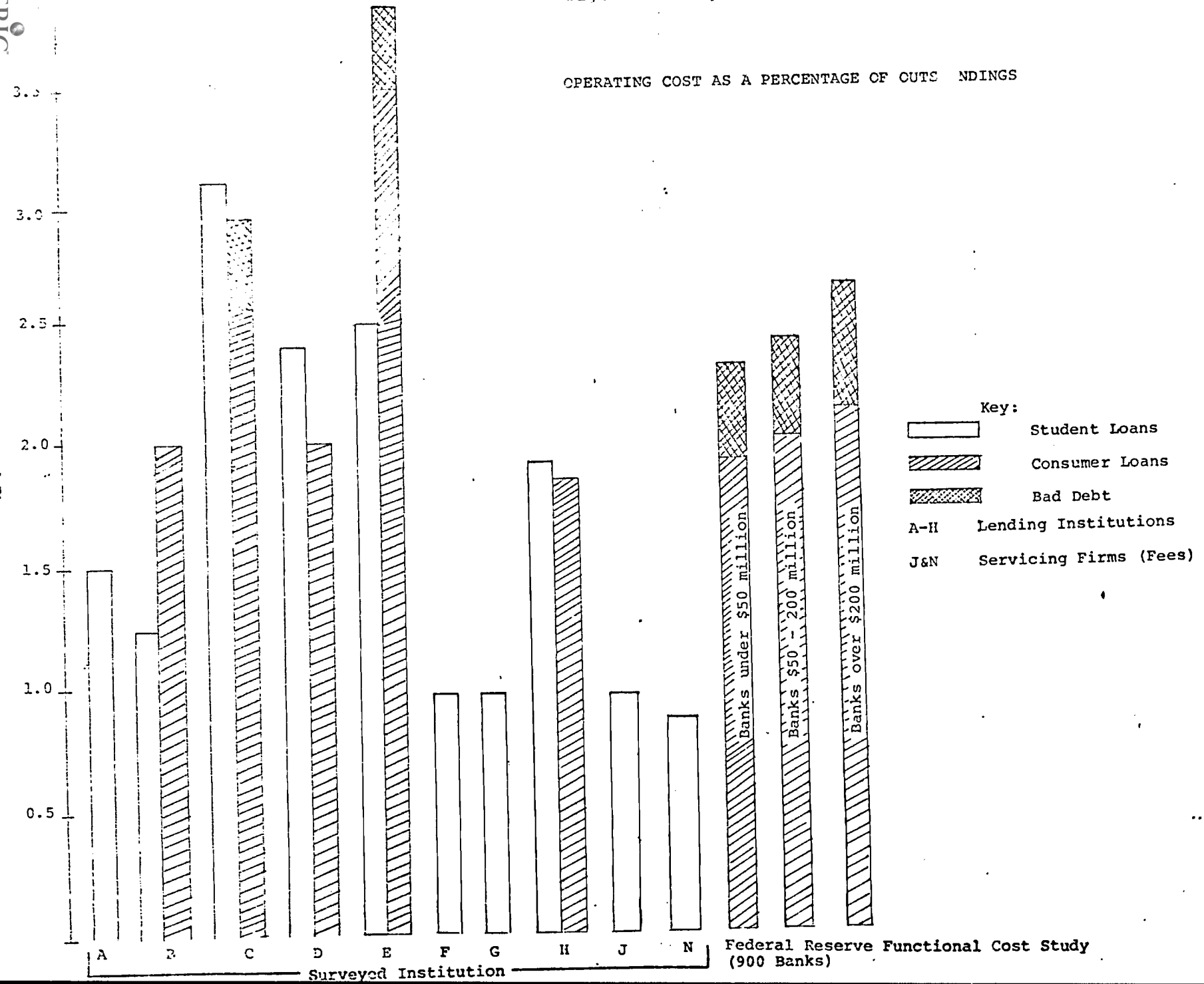
Profit Margin = Revenue - Cost of Funds - Servicing Costs

Figure 2.1 compares servicing costs for student loans and other consumer loans from several sources. If the high cost extreme of 3.1 percent, which results from know system inefficiencies, and the low cost service bureau figures of 1 percent are deleted, the average student loan servicing cost is 1.65 percent of outstandings per year. The comparable figure for all other consumer loans is 2.0 percent and with the addition of losses from bad debts approximates 2.4 percent to 2.5 percent.

One explanation for the lower cost of student loans is that over half of the loans outstanding are typically not yet in repayment status.

Figure 2.1

OPERATING COST AS A PERCENTAGE OF OUTS NDINGS



For those individual banks where direct comparisons between student and other consumer loan costs were available from the same source, student loan servicing costs were less in two cases, greater in two others, and about equal in another. The general perception of higher student loan servicing costs as compared with other consumer loans is generally inaccurate, based on this limited sample.

It is important to note, however, that the acquisition and conversion to repayment costs are considerably higher for student loans. That portion of these costs incurred in the branches are not included in the figures shown. The time of branch personnel spent in booking new consumer laons is not considered to be an incremental cost for student loans and is also omitted from the cost data on other consumer loans.

From the limited sample data available to this study, there is no apparent relationship between operating costs and size of the lending institution or student loan portfolio. Only the largest institutions were included in the study, however, with assets ranging from $1 billion to over $30 billion and student loan portfolios from $1 million to $150 million.

There is a high aggravation factor associated with the procedures involved in booking student loans. Typically, six weeks to two months elapsed time is required to payout a new loan. Even though all of this branch acquisition and conversion effort may not show up in the cost data, it does add to the general dissatisfaction and perception of unprofitability that prevails.

The primary factor in profitability, however, is that revenues have been considerably less for student loans than for other consumer loans. Recognizing that revenues for consumer loans vary significantly among loan instruments and from state to state, each with different rate ceilings, a representative rate of 11 percent has been chosen in order to make the following profitability comparison:

	Student Loans 1970 to 1974 (% Per Year on Outstandings)	Other Consumer Loans 1970 to 1974 (% Per Year on Outstandings)
Av Revenue	8.47	11.00
Av Cost of Bought Funds	6.50	6.50
Spread	1.97	4.50
Av Servicing Cost	1.65	2.10
Bad Debt Losses	-	.40
Total Operating Expense	1.65	2.50
Av Profit Margin	.32	2.00

These figures are averaged over a 17 quarter period from January 1, 1970 to March 31, 1974. Overall, student loans are shown to have been slightly profitable, although in 7 of 17 quarters the average profit margin would have been negative.

If it is assumed that student loan servicing costs should grow to be or are comparable with other consumer loan servicing costs, then they clearly would be unprofitable on average.

The following conclusions can be drawn:

- Student loans have been marginally profitable, on average, for commercial banks since 1970. They have clearly been unprofitable for a number of institutions with higher than average cost servicing operations.

- Student loans have been considerably less profitable than other consumer loans since 1970 primarily due to lower revenues, not higher operating costs.

2.2 Factors Affecting Lending Institution Participation in the Student Loan Program

Most banks have been participating in the student loan program out of a sense of social responsibility, despite the perceived unprofitability and aggravation of government imposed procedures.

The larger city banks have by and large not restricted the funds made available for this program. The particular level or expectations of the special rate allowance (SRA) in the past has not really affected the banks' participation. The SRA is generally viewed, however, as too little too late. The uncertainty of its amount, as determined on a quarter to quarter basis, when booking loans for terms approaching 10 years makes it ineffective in planning for future profits.

Some city banks do restrict the availability of student loan funds by imposing such qualification requirements as:

- student or family must have an active checking or savings account with the bank during the past six months or year;
- freshmen are not eligible;
- not all educational institutions are eligible, e.g., proprietary schools;
- cross borrowing may not be allowed, i.e., loans to students who have loans from other lending institutions; and
- maximum amounts which can be borrowed in a given year or for a particular education program may be less than that allowed under the state or federal guarantee program.

Those thrift institutions interviewed during the study indicated an even greater restrictive policy regarding student loans. Because of the recent disintermediation causing funds to flow out of savings accounts into other higher rate, short-term investments, some savings banks and savings and loan associations have virtually stopped participating in the program, except to see students through a program already started.

In most of these cases, a good cost-profitability analysis had not even been made. The demand for mortgage money clearly took first priority, and the general aggravation factor, not the numbers, convinced these institutions that student loans were unprofitable.

While commercial banks in the past have been participants in the student loan program because of a social commitment and some hopes of acquiring future banking customers, future policy decisions are apt to be made on a more business-like basis, i.e.:

- A bottom line justification will be demanded more frequently.
- The transient nature of the graduating student population make the prospect of acquiring new banking relationships a remote one.

Even though these loans are guaranteed, eventually by the federal government, there is a disinclination by many lending institutions to grant loans in situations where the risk of default is unduly high. They view the granting of such loans as contributing to a breakdown in lending integrity. They believe strongly that the need for student grants should be more clearly established and that student loans should be run on a more business-like basis. This implies a more effective collection effort by the federal government after claims are paid to lending institutions.

The profitability on student loans does not have to be comparable with other consumer lending instruments to ensure that sufficient funds are made available by lending institutions. Banks must be convinced, however, that:

- The student loan program will at least break even or return some minimum profit margin on a continuing basis.
- Operating procedures will become more efficient and less alien to their other consumer lending operations, with a reduction in the current aggravation factor.
- A greater integrity in lending can be achieved with student loans.

2.3 Need for a Special Rate Allowance Index

All lending institutions interviewed agreed that the uncertainty in the determination of the current SRA was a problem. The past amounts and delays in payment were considered unsatisfactory.

The suggestion of a money market related index as a basis for determining the SRA met with uniform approval. Assuming the index would be set in a way that maintained a reasonable spread over the cost of funds, the certainty of knowing the basis for student loan revenue determination would go a long way toward justifying the student loan program on a bottom line basis.

Some institutions would prefer that such an index be pegged to prevailing consumer loan rates, but most considered that alternative impractical and preferred a money market, e.g., U.S. Treasury or Federal Agency Security, rate source.

Even though the SRA would vary every quarter, the certainty of the basis for its determination and the ability to plan revenues from a known and visible index would make the SRA a much more effective inducement for lending institutions to participate in the student loan program.

More regularity and promptness in disbursing the quarterly payments would also aid in this process.

2.4 Criteria for a Special Rate Allowance Index

Before a special rate allowance index can be structured, it is necessary to establish some specific criteria by which its effectiveness can be measured.

The basic objective of the supplemental rate allowance, when added to the amount paid by the student, is to provide lending institutions with a sufficiently attractive margin so that they will continue to make funds available to students in need of loans. As the lending institution's cost of funds changes over time, the total revenue should change so as to maintain a somewhat stable spread between revenue and cost of funds. This spread should be sufficient to cover servicing costs and provide some margin of profit.

Because of the unique social value of the program, government guarantees and the source of secondary market liquidity to be provided by the Student Loan Marketing Association (SLMA), direct comparisons with other consumer loan instruments may not be appropriate. For example, consumer loan rates in general remain relatively stable as the cost of funds fluctuate widely over time. Thus, consumer loan instruments have widely fluctuating profit margins over time.

Rather than have profit margins on student loans subject to this same variability, which would occur if the special rate allowance tracked a consumer loan rate index, it seems preferable to maintain stable margins rather than stable revenues over time. In addition, a single consumer loan rate index would be difficult to structure because of the varying rate ceilings and differences among consumer loan instruments.

An especially important consideration is the SLMA, whose ability to provide a liquid market for student loans is directly related to the spread between its cost and uses of funds. The method of setting the special rate allowance determines the revenue earned on loans purchased by SLMA. Since its cost of funds are determined by prevailing interest rates in the government security market, a strong argument can be made for using an index which protects the spread between student loan revenue and some representative money market rate for U.S. Treasury and Agency securities.

When considering the cost of funds to lending institutions, several factors complicate this issue, namely:

- the distinction between a lending institution's marginal and its average cost of funds; and
- the differences in sources of funds between thrift institutions and commercial banks, and even between city and country commercial banks.

It is normal procedure for consumer loan departments to be charged with the "marginal" cost of funds for purposes of profit center accounting. The marginal cost of funds relates to the bank's most costly sources of funds which it utilizes to complete the financing of its loan position and to assure adequate liquidity.

Typically, marginal fund sources for commercial banks include such instruments as:

- FED funds;
- certificates of deposit;
- Eurodollar deposits; and
- bank notes and commercial paper.

For thrift institutions, they include such instruments as:

- federal funds;
- savings certificates; and
- Federal Home Loan Bank advances.

The average cost of all sources of funds would reflect a weighted average cost across all sources of bank funds, including demand deposits and savings accounts.

Figure 2.2 summarizes some representative figures on the historical cost of funds to commercial banks during the 1970-1974 period. The cost of funds has been defined in three categories, i.e.:

- a true incremental rate—the 90 day certificate of deposit;
- the average cost of all bought funds, including all time deposits and borrowings; and
- the average cost of all sources of funds, including demand deposits, savings accounts and other sources of capital.

The variability increases, naturally, from the average of all sources to average bought to incremental.

The most useful cost of funds measure for evaluating spreads and profit margins is the average cost of bought funds, which is a weighted average rate composed of:

- savings deposits;

Figure 2.2

REPRESENTATIVE COST OF FUNDS DATA FOR COMMERCIAL BANKS

	Federal Reserve Functional Cost Analysis		A Major Commercial Bank[1]		
	Avg Cost of All Fund Sources (Percent/Year)	Avg Cost of Time Deposits (Percent/Year)	Avg Cost of All Fund Sources (Percent/Year)	Avg Cost of Bought Funds (Percent/Year)	Incremental Cost 3 Month CD Rate (Percent/Year)
1970 - 1					
2	3.56 to 3.85	5.26 to 5.69		7.68	
3					
4					
1971 - 1					
2	3.50 to 3.80	5.30 to 5.31		5.16	
3					
4					
1972 - 1			2.41	4.70	4.05
2	3.50 to 3.86	5.08 to 5.30	2.52	4.82	4.70
3			2.68	5.03	5.10
4			2.80	5.31	5.49
1973 - 1			3.44	6.00	6.59
2			4.16	6.90	7.84
3			5.57	8.67	10.87
4			5.92	9.09	9.88
1974 - 1			5.84	8.76	9.07
2					11.39

[1]Published data available from First National Bank of Boston

- time deposits:
  - notice accounts, and
  - certificates of deposit;
- borrowed funds:
  - FED funds,
  - repurchase agreements,
  - bank notes and commercial paper, and
  - Federal Reserve window;
- Eurodollar deposits.

It is this measure which is closest to the figure used by consumer loan management in computing profitability for each loan product.

In the subsequent evaluation of alternative SRA indices, one measure of effectiveness will be the spread maintained against the average cost of bought funds. Figure 2.3 shows a plot of these historical costs along with two selected New York City consumer loan rates over the same period.

The analagous consideration in the case of thrift institutions involves the use of rates for:

- FED funds,
- FHLB loans,
- savings certificates, and
- other time deposits

as the equivalent average cost of bought funds.

Figure 2.4 illustrates how the average cost of all sources of funds, including all savings accounts, has varied over the 1970-1973 time period versus FHLB loan rates and mortgage loan rates.

With the increasing ability of thrift institutions, including both savings banks and savings and loan associations, to raise money through a variety of time deposit instruments and borrowings (e.g., FED funds) similar to instruments used by commercial banks, the same cost of bought funds will become applicable to both in the future.

Figure 2.3

COMMERCIAL BANK RATE HISTORY

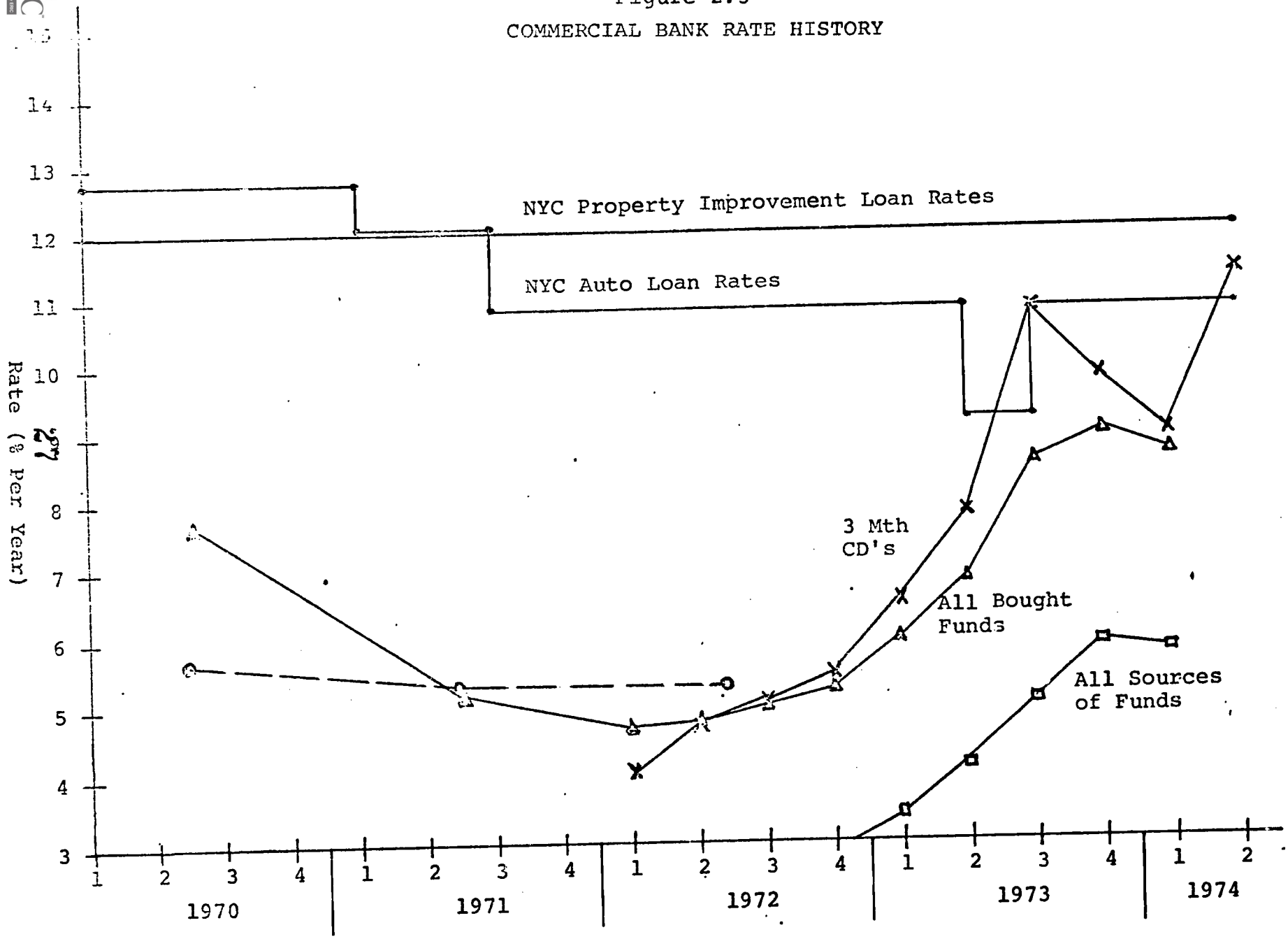
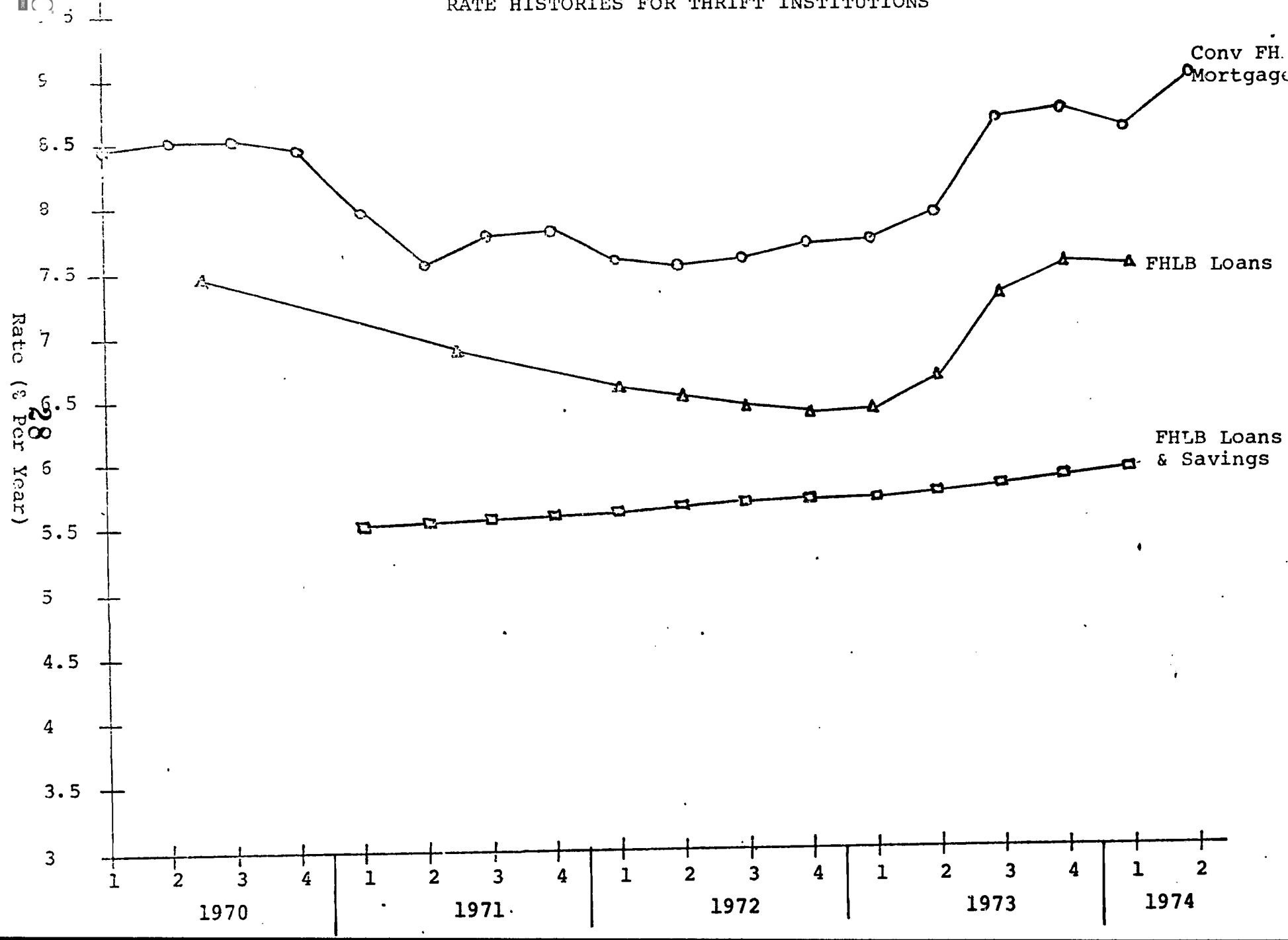


Figure 2.4

RATE HISTORIES FOR THRIFT INSTITUTIONS



There are other very practical considerations affecting the choice of an SRA index, namely that it:

- reflects a true free market determination;
- is readily visible and has a continuing source of data; and
- is practical to compute on a continuing basis.

Ideally, the rate source would be a regularly scheduled (no less frequent than once a month) new debt issue of constant maturity by the Treasury or a Federal Agency.

In order that lending institutions are consistently motivated to make funds available for student loans during periods of changing interest rates, it is necessary for the index to have a variability which correlates well with variability in the cost of funds.

In order that student loans are viewed to be profitable by lending institutions, the average level of the index should provide a sufficient margin over the cost of funds to cover reasonable servicing costs and a profit margin under most market conditions. The margin on student loans need not match that of comparable consumer lending instruments, but it should be positive on average, given reasonably efficient servicing.

The criteria which should be used in establishing an SRA index can be summarized as follows:

- A money market rate source should be used which has a variability that is highly correlated with the variability in average cost of bought funds for commercial banks, thrift institutions and SLMA.
- The average level of the SRA index should be set so as to maintain a fairly constant spread over the average cost of bought funds to cover for reasonable servicing costs and a profit margin for commercial banks and thrift institutions. The average level of the SRA should also maintain a reasonable and stable operating spread for SLMA against its cost of funds as represented by the Government and Agency security market.

- The money market instrument or instruments used for the SRA index should:
  - reflect a true free market rate determination;
  - be readily visible and have a continuing source of access; and
  - be practical to compute.

  A preferable rate source would be a regularly scheduled (monthly or weekly) new debt issue of constant maturity by the Treasury or a Federal Agency.

2.5 Payment Frequency

Currently the Special Rate Allowance is determined and paid quarterly based on prevailing interest rates during the preceding quarter. It was requested that alternatives to this payment procedure be considered, such as fixing the SRA on all new loans in a quarter for the life of the loan.

Because of the increasing average terms of student loans, now approaching ten years, and the projected volatility in interest rates, a fixed rate for the life of the loan would have to be sufficiently high to compensate for this uncertainty. If it approaches, on average, the rates charged for other consumer loans, this could become unduly costly to HEW.

In addition, loan processing for the banks would become more complex because of the differing rates to be charged on individual loans. There doesn't seem to be any particular advantage to fixing rates for the life of a loan each quarter and some potential disadvantages in terms of cost and operational complexity.

Under the philosophy that the purpose of the SRA is to maintain adequate spreads over the cost of funds for lending institutions and SLMA under varying market conditions and incur a minimum cost to HEW in so doing, a quarterly rate determination period appears to be as effective as any. As long as the rate basis is the average (daily or weekly) over the payment period, the only effect of extending the length of the period is the interest on interest lost by the lending institution or a possible savings in HEW's processing costs due to fewer payment periods per year.

Since the current payment period is quarterly, it is recommended that it not be changed.

2.6 Analysis of Alternative SRA Indices

In evaluating alternative SRA indices, three sources of representative cost of funds data were used to compute spreads each quarter from January 1, 1970 to March 31, 1974. These sources are shown in Figure 2.5.

Based on the relative importance of each source of funds for the student loan program, the commercial banks, accounting for some 85 percent of current outstandings, are a primary consideration. The anticipated future level of SLMA's operations, when providing a full secondary market for student loans, makes this agency's viability also a prime consideration. It has been assumed that average cost of funds to SLMA would approximate an average of the yields on 90 day Bills, 1 year Agencies, and 3 year Agencies.

Figure 2.6 was prepared to show how the yields on Treasury securities of varying maturity and Federal Funds (representing a 1 day maturity) have varied over the 1970 to 1974 period. This plot illustrates visually that the longer the maturity, the less variable the yield over time. The variability of an index can thus be controlled to an extent through selection of the appropriate maturity mix.

To show the relative behavior of alternative indices, the following four were selected for comparative purposes:

- Index 1: 3 month Treasury + 3 percent;
- Index 2: 7 year Treasury Bonds + 3 percent;
- Index 3: 3 year Agencies + 3 percent;
- Index 4: Composite: .33 3 month bill,
  .33 1 year Treasury Bond,
  .33 5 year Treasury Bond.

The results of these calculations for each quarter, shown with and without constraints, are tabulated in Figure 2.7. Each index is plotted along with the actual SRA + 7 percent and the cost of funds for commercial banks in Figures 2.8 through 2.11.

Figure 2.5

REPRESENTATIVE COST OF FUNDS DATA

Time Period	Commercial Banks: Average Cost of Bought Funds Source—One Leading Commercial Bank	Thrift Institutions: National Weighted Average Rate on FHLBB Advances Outstanding (Cost of Borrowed Funds)	SLMA: Average Cost (1/3 Each of 1 Yr Agency, 3 Yr Agency, 90 Day Treasury Bills)
1970	7.68	7.485	7.245
1971	5.16	6.921	5.246
1972 - 1	4.70	6.673	4.569
- 2	4.82	6.570	4.903
- 3	5.03	6.486	5.263
- 4	5.31	6.423	5.586
1973 - 1	6.00	6.450	6.301
- 2	6.90	6.706	7.025
- 3	8.67	7.343	8.451
- 4	9.09	7.660	7.525
1974 - 1	8.76	7.620	7.514

Figure 2.6

COMPARATIVE TREASURY & FED FUNDS RATE HISTORY

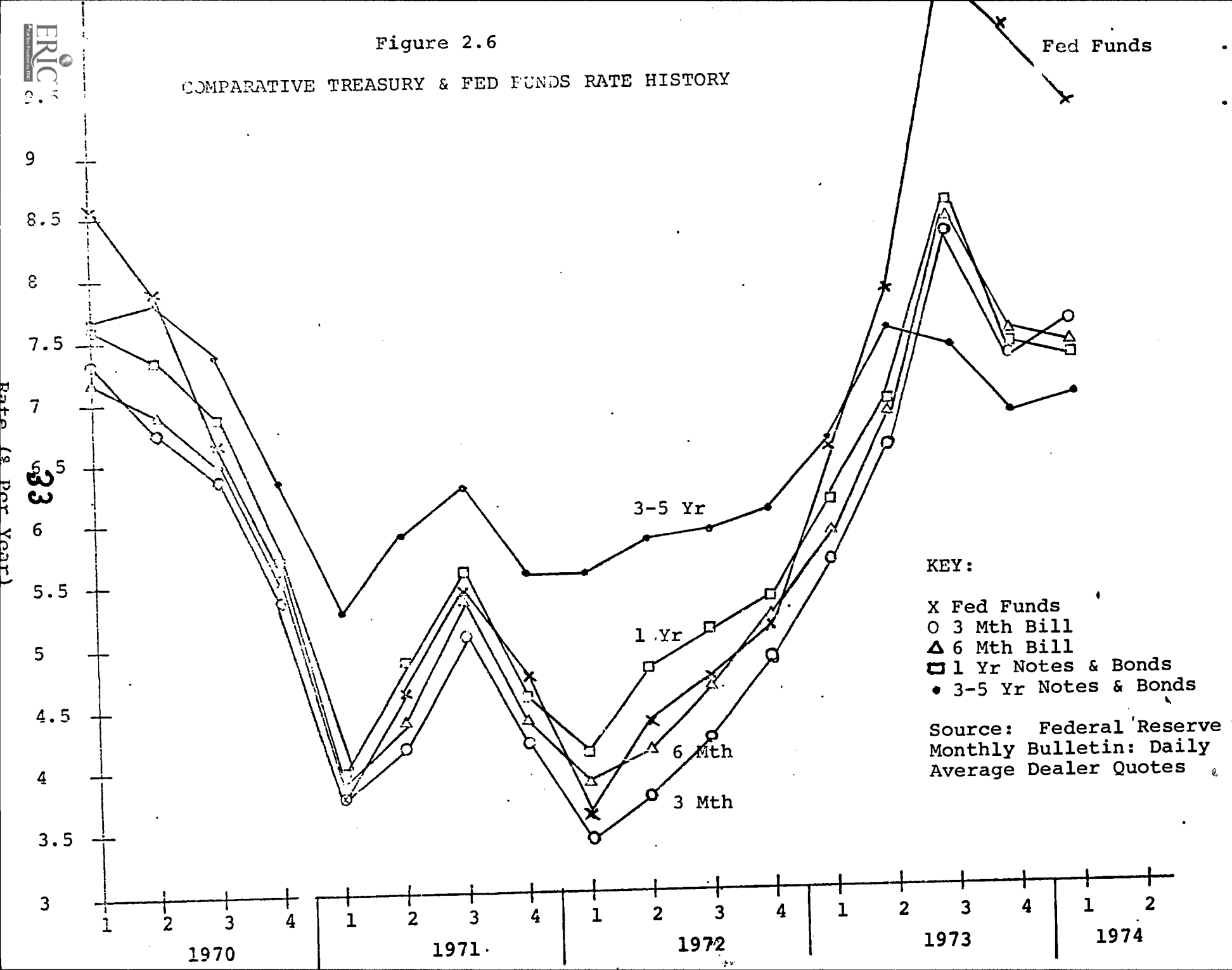


Figure 2.7

INDEX RATE COMPARISONS

	Actual SP Rate All + 7%	Index 1		Index 2		Index 3		Index 4	
		Unconstr.	7% Min 11% Max	Unconstr.	7% Min 11% Max	Unconstr.	7% Min 11% Max	Unconstr.	Min 11% Max
1970 - 1	9.0	10.21	10.21	10.44	10.44	11.24	11.00	10.49	10.49
2	9.25	9.64	9.64	10.75	10.75	11.16	11.00	10.28	10.28
3	9.0	9.33	9.33	10.54	10.54	10.89	10.88	9.91	9.91
4	8.5	8.34	8.34	9.74	9.74	9.74	9.74	8.81	8.81
1971 - 1	8.0	6.77	7.00	8.82	8.82	8.47	8.47	7.40	7.40
2	8.25	7.20	7.20	9.27	9.27	9.23	9.23	8.07	8.07
3	8.25	8.03	8.03	9.61	9.61	9.86	9.86	8.77	8.77
4	7.75	7.21	7.21	8.95	8.95	8.88	8.88	7.90	7.90
1972 - 1	7.75	6.43	7.00	9.00	9.00	8.70	8.70	7.53	7.53
2	7.75	6.77	7.00	9.11	9.11	8.92	8.92	7.85	7.85
3	7.75	7.22	7.22	9.25	9.25	9.13	9.13	8.15	8.15
4	7.75	7.87	7.87	9.24	9.24	9.19	9.19	8.48	8.48
1973 - 1	8.0	8.72	8.72	9.59	9.59	9.72	9.72	9.22	9.22
2	8.75	9.60	9.60	9.77	9.77	10.11	10.11	9.77	9.77
3	9.5	11.25	11.25	10.27	10.27	11.09	11.00	11.01	11.00
4	9.5	10.48	10.48	9.80	9.80	10.35	10.35	10.22	10.22
1974 - 1	9.25	10.64	10.64	10.06	10.06	10.31	10.31	10.35	10.35
2		11.10	11.00	10.86	10.86	11.53	11.00	11.24	11.00
	Average Rate:		8.76		9.72		9.86		9.17

Index 1 - 3 Month Treasury Bill + 3%

Index 2 - 7 Year Treasury Bonds + 3%

Index 3 - 3 Year AGencies + 3%

Index 4 - Composite: .33 3 Month Bill
.33 1 Year Treasury Bond
.33 5 Year Treasury Bond

Source of Money Market Rates:

Daily Average Closing Quotes
Prepared by NY Federal Reserve Bank
... Multiple Dealer Quotes

Figure 2.6

INDEX 1 VERSUS COMMERCIAL BANK COST OF FUNDS

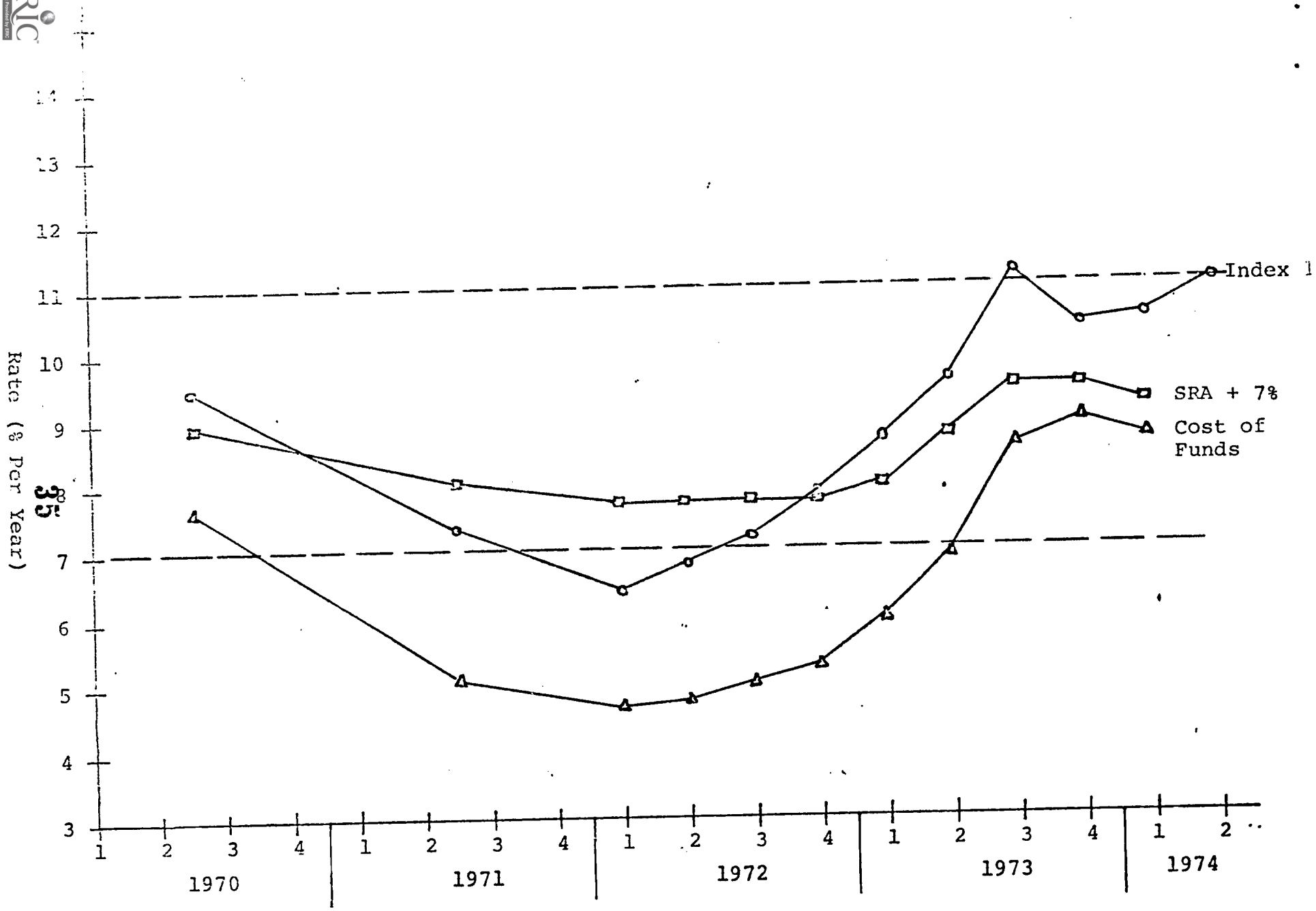


Figure 2.9

INDEX 2 VERSUS COMMERCIAL BANK COST OF FUNDS

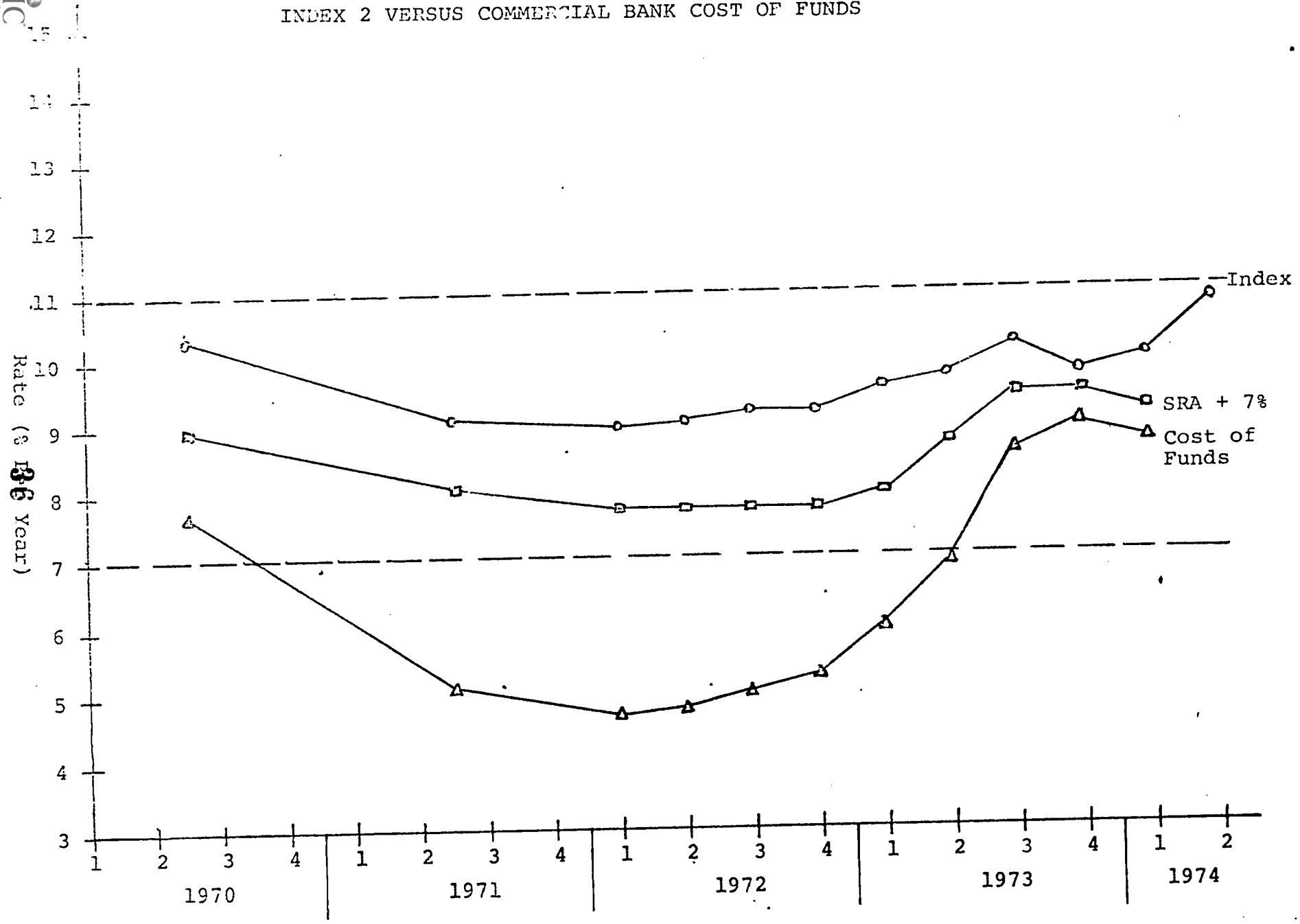


Figure 2.10

INDEX 3 VERSUS COMMERCIAL BANK COST OF FUNDS

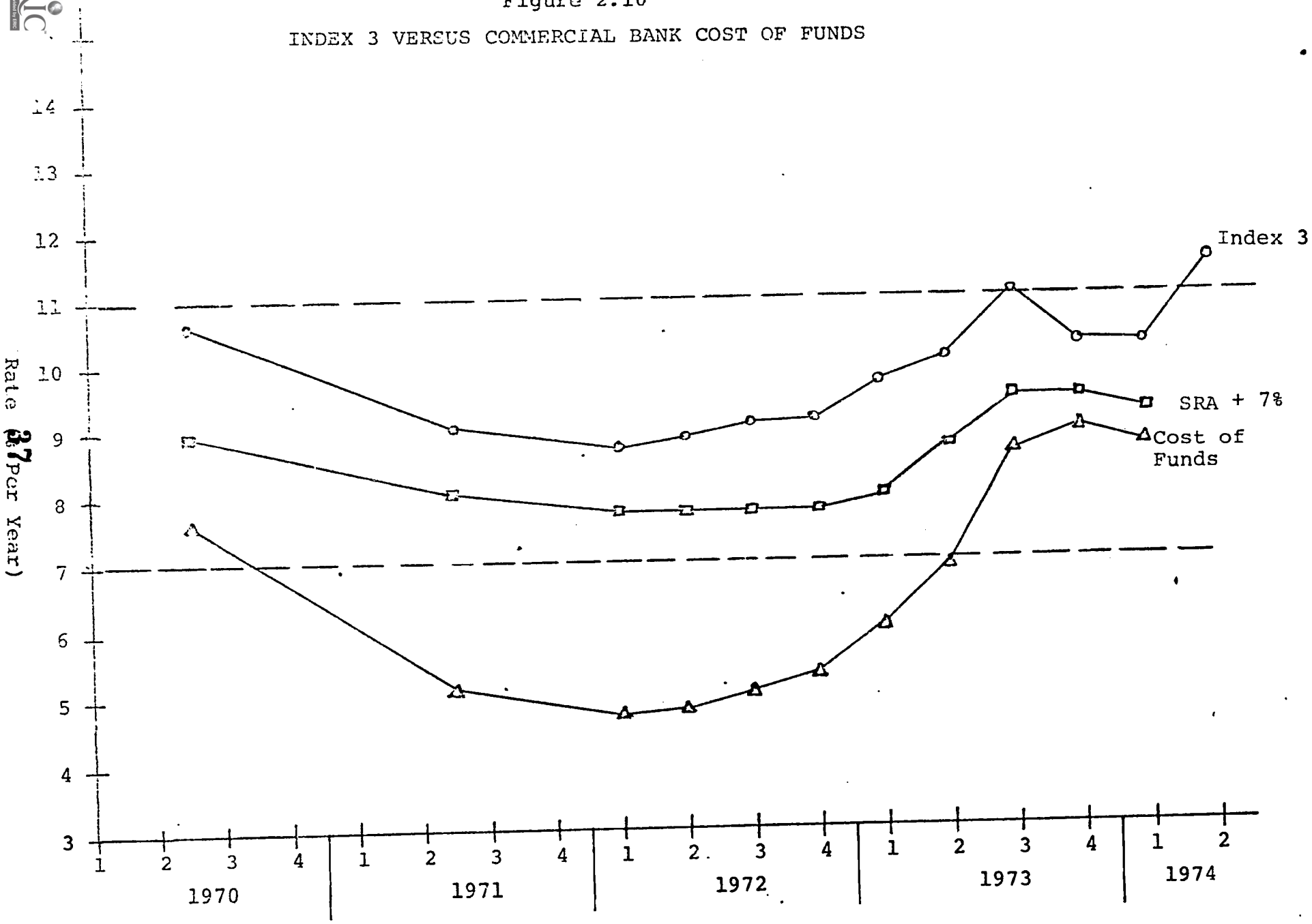
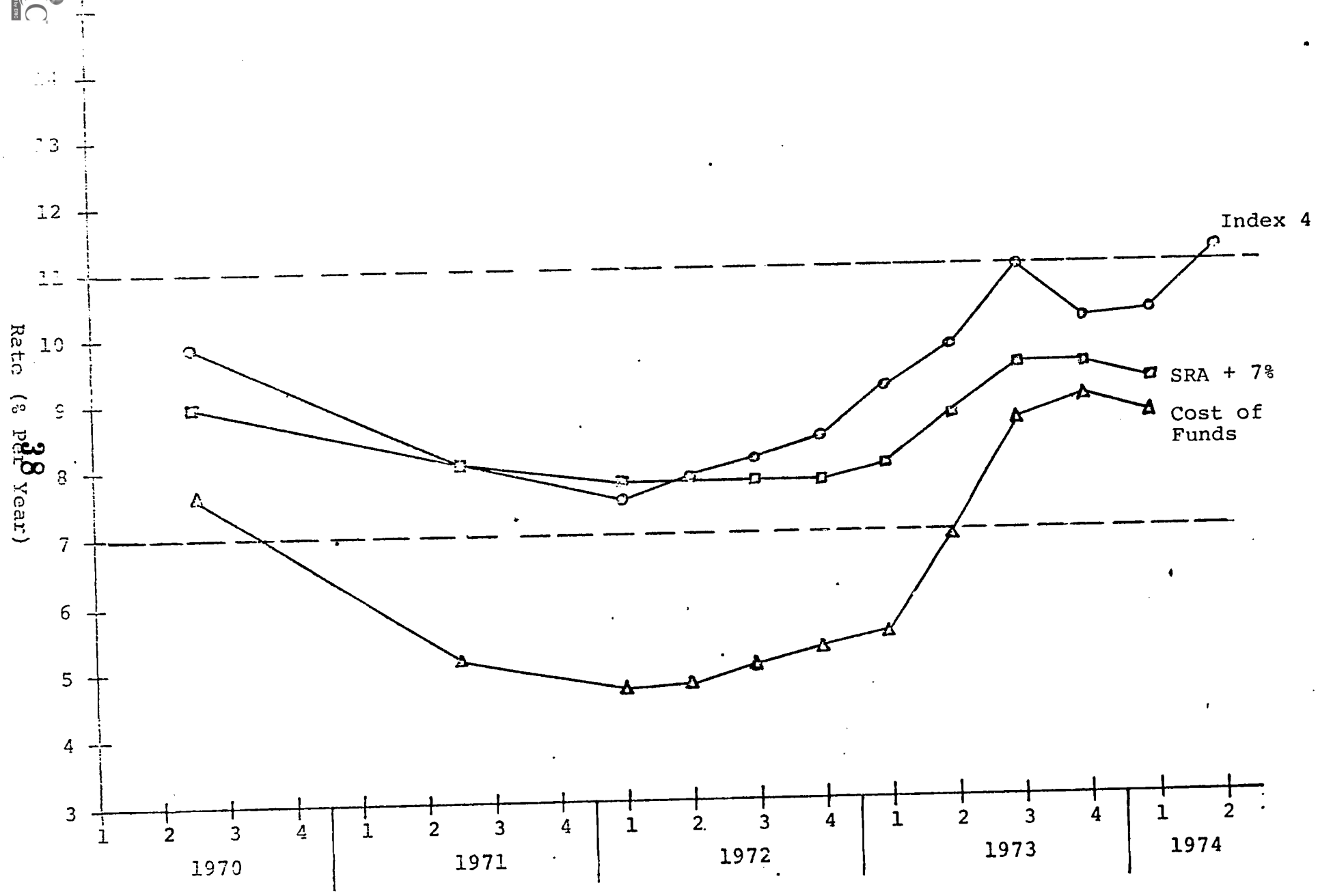


Figure 2.11

INDEX 4 VERSUS COMMERCIAL BANK COST OF FUNDS



The addition of 3 percent to indices 2 and 3 is obviously excessive in comparison to indices 1 and 4, if the same average rates are to be achieved. More like a 2 percent add-on to indices 2 and 3 would be equivalent.

The main purpose of this analysis, however, is to compare the changes in spread over the cost of funds. The add-on amounts can be easily adjusted and will not affect variability in spread.

In comparing stability of spreads, index 1, and to a lesser extent index 4, maintain the most consistent margins over the cost of funds, probably because the average maturity of bought funds for commercial banks is under 1 year year and therefore more closely tracks the 3 month Treasury Bill rate.

On the theory that the index should maintain a consistent spread over time, index 1 is preferred. In addition, Treasury Bills satisfy the other criteria established for an index, i.e.:

- There is a new debt issue and auction rates are announced weekly for 3 month and 6 month bills and every 4 weeks for 1 year bills.
- A continuing single source of rates is assured for a constant maturity issue.
- The rate source is visible, can be easily computed, and is based on a free market determination.

For these reasons, it was decided to concentrate on Treasury Bills as the preferred source of a rate index.

Figure 2.12 shows a comparison of three bill indices, each with a 3 percent add-on and the past SRA + 7 percent. The rate spreads over cost of funds for these three indices plus the 3 month bill with a 3.5 percent add-on are tabulated in Figure 2.13.

These indices are compared in Figure 2.13 on the basis of average spread and the average deviation around the mean spread over the 17 quarter period from 1970 to 1974. The lowest average deviation is achieved with the 3 month bill [illegible] or A1. Depending on the average level of desired spread, an add-on of between 3 percent and 3.5 percent seems appropriate, assuming a lower limit of 0 percent and an upper limit of 4 percent for the SRA.

Figure 2.12

SELECTED RATE INDICES WHICH MEET ESTABLISHED CRITERIA

Time Period	Index A 3 Month Treasury Bills[1] +3%	Index B 6 Month Treasury Bills[1] +3%	Index C 1 Year Treasury Bills[2] +3%	SRA + 7%
1970	9.438	9.562	9.49	8.94
1971	7.348	7.511	7.67	8.06
1972 - 1	6.435	6.778	7.103	7.75
- 2	6.748	7.184	7.606	7.75
- 3	7.241	7.732	8.080	7.75
- 4	7.851	8.161	8.623	7.75
1973 - 1	8.639	8.902	9.013	8.00
- 2	9.608	9.791	9.730	8.75
- 3	11.388	11.439	11.120	9.50
- 4	10.461	10.508	10.193	9.50
1974 - 1	10.600	10.443	9.953	9.25

Notes: 1 - Average of Weekly Treasury New Issue Auction Rate
2 - Average of Monthly Treasury New Issue Auction Rate

Figure 2.13

SPREADS OVER AVERAGE COST OF BOUGHT FUNDS OF COMMERCIAL BANKS FOR A NUMBER OF INDICES

Time Period	Index A 3 Month Treasury Bills + 3%	Index A1 3 Month Treasury Bills + 3.5%	Index B 6 Month Treasury Bills + 3%	Index C 1 Year Treasury Bills + 3%	SRA + 7%
1970	1.78	2.28	1.88	1.81	1.26
1971	2.19	2.69	2.35	2.51	2.90
1972 - 1	2.30	2.80	2.30	2.40	3.05
- 2	2.18	2.68	2.36	2.79	2.93
- 3	2.21	2.71	2.70	3.05	2.72
- 4	2.54	3.04	2.85	3.31	2.44
1973 - 1	2.64	3.14	2.90	3.01	2.00
- 2	2.71	3.21	2.89	2.83	1.85
- 3	2.72	3.22	2.77	2.45	.83
- 4	1.37	1.87	1.42	1.10	.41
1974 - 1	1.84	2.34	1.68	1.19	.49
Average	2.14	2.64	2.28	2.32	1.96
Mean Absolute Deviation	.30	.30	.36	.51	.83

Figures 2.14 and 2.15 compare the spreads of indices A and A1 over the cost of funds for thrift institutions and SLMA. Index A, while adequate for SLMA, would have been inadequate in 1971 and much of 1972 for thrift institutions. However, if a combined cost of funds measure were used, accounting for notice savings accounts, this index might be adequate.

The past and projected impact on the total cost to HEW for SRA payments under proposed indices A and A1 are shown in Figure 2.16. The net differences in cost compared with past SRA policies are as follows:

	Additional Payments			
	1970-74		1976-80	
	$Million	%	$Million	%
Index A	19	16	39	12
Index A1	58	48	145	43

2.7 Recommendations

It is recommended that the future special rate allowance for student loans be paid at the end of each quarter on the basis of the following index:

- The rate source should be the discount yield of new 3 month Treasury Bill issues, as announced by the Federal Reserve Bank of New York, each week, and averaged over all weekly auctions included in the quarter just completed.

- The annualized Special Rate Allowance for the quarter just completed would be computed as follows:

  Total Lending Institution Revenue =
  [Av 3 Month Bill Rate + 3%]

  Special Rate Allowance =
  [Av 3 Month Bill Rate -4%]

  $$\text{Payment} = \frac{\text{SRA}}{100}\left[\frac{\text{Cal Days in Qtr}}{\text{Cal days in Yr}}\right] \times \left(\text{Av Daily Loan Balance Outstanding}\right)$$

Figure 2.14

SPREAD OF INDEX A AND SRA OVER WEIGHTED AVERAGE RATE ON FHLBB ADVANCES OUTSTANDING (COST OF BORROWED FUNDS FOR THRIFT INSTITUTIONS)

Time Period	Index A 3 Month Treasury Bills + 3%	Index A1 3 Month Treasury Bills + 3.5%	SRA + 7 %
1970	1.97	2.47	1.46
1971	.43	.93	1.14
1972 - 1	.33	.83	1.08
- 2	.43	.93	1.18
- 3	.76	1.26	1.26
- 4	1.43	1.93	1.33
1973 - 1	2.19	2.69	1.55
- 2	2.90	3.40	2.04
- 3	4.05	4.55	2.16
- 4	2.80	3.30	1.84
1974 - 1	2.98	3.48	1.63
Average	1.62	2.12	1.44
Mean Absolute Deviation	.97	.97	.25

Figure 2.15

SPREAD OF INDEX A AND SRA OVER WEIGHTING OF
90 DAY TREASURY BILLS AND 1 AND 3 YEAR AGENCY ISSUES
(A SURROGATE FOR SLMA'S COST OF FUNDS)

Time Period	Index A 3 Month Treasury Bills + 3%	Index A1 3 Month Treasury Bills + 3.5%	SRA + 7%
1970	2.21	2.71	1.70
1971	2.10	2.60	2.81
1972 - 1	2.43	2.93	3.18
- 2	2.10	2.60	2.85
- 3	1.98	2.48	2.49
- 4	2.27	2.77	2.16
1973 - 1	2.34	2.84	1.70
- 2	2.58	3.08	1.73
- 3	2.94	3.44	1.05
- 4	2.94	3.44	1.98
1974 - 1	3.09	3.59	1.74
Average	2.35	2.85	2.17
Mean Absolute Deviation	.26	.26	.53

Figure 2.16

IMPACT ON SPECIAL ALLOWANCE PAYMENTS

Time Period	Estimated Outstanding Balances ($Billion)	Current Special Rate Allowance ($Million)	Index A 3 Month Bill + 3% ($Million)	Index A1 3 Month Bill + 3.5% ($Million)
1970 - 1	.33	1.67	2.68	3.10
- 2	.57	3.22	3.79	4.50
- 3	.79	3.95	4.61	5.60
- 4	1.78	4.42	3.95	8.18
1971 - 1	1.99	4.97	-	1.34
- 2	1.09	3.40	.54	1.90
- 3	1.53	4.79	3.94	5.86
- 4	2.86	5.36	1.49	5.08
1972 - 1	2.07	3.89	-	-
- 2	2.22	4.16	-	1.50
- 3	2.49	4.67	1.34	4.48
- 4	2.50	4.69	5.45	8.56
1973 - 1	2.23	5.57	9.55	12.36
- 2	1.75	7.65	11.37	13.55
- 3	2.20	13.73	23.37	26.10
- 4	3.37	21.06	29.30	33.53
1974 - 1	4.15	23.37	37.78	43.00
TOTAL		120.57	139.16	178.64
Projection at Past Av Rates*				
1976	3.25	47.78	53.30	68.25
1977	4.04	59.39	66.26	84.84
1978	4.71	69.24	77.24	98.91
1979	5.24	77.03	85.94	110.04
1980	5.77	84.82	94.63	121.17
TOTAL		338.26	377.37	483.21

*1.47 percent for Current Special Rate Allowance, 1.64 percent for 90 Day Treasury Bills plus 3 percent, and 2.10 percent for 90 Day Treasury Bills plus 3.5 percent.

- The SRA would range from 0 to a maximum of 4 percent, thus total revenue would range from 7 percent to 11 percent on an annual basis.

It is further recommended that the adequacy of this index be reviewed every one to two years and adjusted as needed to account for any changes in the relationship of servicing costs as a percent of outstandings or in the spread between revenue and cost of funds.

The recommended index would have maintained an adequate and reasonably constant spread over the cost of funds since 1970 and would have increased SRA payments by only $19 million, or 16 percent, over 1970 to 1974.

3. STUDENT LOAN OPERATIONS

3.1 Objectives and Scope of Analysis

The second part of this study addressed student loan operations. For a group of 16 lenders and student loan servicing firms, interviews were conducted and/or data obtained with three objectives in mind:

- to document student loan operating costs so as to permit the mechanism for setting interest rates to reflect such costs (see previous section);
- to identify where procedural changes might have a significant impact on reducing operating costs; and
- to assess the extent to which certain GSL program changes might affect operating costs.

The 16 lending and servicing institutions that contributed to the study were extremely cooperative in making highly confidential revenue and cost data available. In the interest of maintaining that confidentiality, none of the participating institutions are named in this report.

Thirteen of the institutions are lenders, including:

- 9 commercial banks doing business in 2 East Coast metropolitan areas (New York and Boston) and in California. Five of the 9 operate under state-guaranteed programs. All have been in either state or federal guaranteed student loan programs virtually since their inception.
- 2 Eastern savings banks. Both institutions have operated under state programs since the late 1950's. Although their GSL volumes are low compared to the commercial banks, both are significant participants in the program.
- 2 savings and loan institutions, one in the Midwest, the other in California.

The remaining 3 institutions service student loans for lenders on a fee basis.

The interviewing and data gathering undertaken at each participating institution followed a similar pattern:

- Operating philosophies and practices were discussed, particularly with respect to student interviewing, credit checking, and collection activity.
- Organizational responsibilities were reviewed in regard to branch versus centralized operations, and "dedicated" versus "mixed" student loan processing activities.
- The use of automated data processing (ADP) support was identified.
- Operating costs were obtained, where available.

In some cases, institutions were recontacted either to clarify certain findings or to obtain data not available during the initial visit.

The sections that follow describe:

- the range of operating practices of lending and servicing institutions;
- student loan operating costs; and
- changes to the program that appear worthy of consideration.

3.2 Student Loan Operating Practices

It was somewhat surprising, given the relatively small number of institutions surveyed, to find a broad range of GSL operating approaches taken by lenders. The operating characteristics of 12 lenders is summarized in Figure 3.1 on each of 4 dimensions:

- Degree of Branch Involvement, from "low" if limited to a short interview to "high" if interviewing (sometimes including parents) and branch-performed functions (e.g., disbursement, note preparation) are extensive.

Figure 3.1

OPERATING CHARACTERISTICS OF GSL LENDERS

Institution	Degree of Branch Involvement	Responsible Organization[1]			Credit Check	ADP Approach[2]	
		Centralized					
		Dedicated	Mixed	Branch		In-School	Repayment
A	Low	I/R			No	S	S
B	Low	I/R			No	P	P
C	Low	I/R			Yes	M	P
D	Low	I/R			No	C	C
E	Med	I	R		No	M	P
G	Low	I/R			No	S	S
H	Low		I/R		No	P	P
K	Med	I	R		No	P	P
L	Med		I/R		Yes	P	P
M	Med		I/R		No	P	P
O	High		I/R		No	M	M
P	High			I/R	No	M	M

[1]Key: I = In-School; R = Repayment

[2]Key: P = Modified Personal Loan; C = Modified Commercial Loan; S = Special Purpose Student Loan; M = Manual

- Responsible Organization, the use of a centralized processing activity (either dedicated to student loans or servicing all consumer loans) or a branch for the bulk of the servicing effort required.

- Credit Checking, i.e., whether the credit record of the applicant (or his parents) is verified by the lender.

- ADP Approach, whether manual or automated either via a modified loan accounting system or a system specifically designed for student loans.

On each of these dimensions, the Figure indicates any differences in the operating approach taken for loans in in-school or repayment status.

3.2.1 Degree of Branch Involvement in Loan Acquisition

As indicated in Figure 3.1, there is a broad range in the degree to which branch offices are involved in the acquisition process, which for origination spans the time from the first appearance of the student until note preparation and disbursement. At six institutions, branches do little more than interview the student and hand out forms. At two institutions, branches are heavily involved in acquisition, including virtually all forms preparation. One of the two even insists on interviewing the parents, either with the student or separately. The remaining four institutions involve their branches at a level between the two extremes; commonly, such involvement includes initial interviewing and disbursement. One of the four performs all acquisition functions centrally the first time a student borrows; subsequent applications for repeat borrowers are, in part, processed at branches.

It is difficult to explain this difference in practice among institutions. Branch processing is generally recognized to be less efficient and more expensive than centralized operation: people are less specialized in student loans and higher paid; space charges are substantially higher. Nevertheless, at least some lenders have opted for a greater-than-minimum amount of branch processing where:

- other consumer loan applications are also branch-processed;

- the desired degree of involvement with the student is high; or

- particularly in the case of thrift institutions or small commercial banks, there is no "back office" where large volumes of like transactions are pooled for efficient processing in specialized departments.

Larger institutions, particularly commercial banks, tend to limit the degree of branch involvement during student loan acquisition, reflecting their traditional approach to high-volume consumer lending and sufficient volume to enjoy the economies of scale of a centralized, specialized processing activity.

3.2.2 Organizational Responsibility

The pattern of low branch involvement during acquisition tends, as Figure 3.1 also shows, to be coupled with an institution's use of a centralized processing department dedicated to student loans. These student loan operating departments typically handle much of the paperwork associated with loan acquisition (both origination and repayment). They also perform all in-school servicing functions and usually repayment servicing also. Seven of the institutions surveyed have student loan departments dedicated to such loans. In two of the seven cases, only in-school processing is performed by the student loan activity; repayment servicing is performed, along with other consumer loans, by installment loan department personnel. Four lenders service student loans within a centralized processing activity but on a mixed basis with other consumer loans. Rather interestingly, two of the four are contemplating reorganization of student loan processing into dedicated departments. One institution—a savings bank—performed all servicing activities in its branches.

Within the pattern described above, the following generalizations can be made:

- Larger institutions now tend to centralize their student loans into activities dedicated to these instruments. The trend is definitely in this direction for such lenders. Although apparently this approach is most efficient, servicing costs are still apparently high because these banks are in large cities where labor and space costs are high.

- Mid-size institutions except, perhaps, for thrift institutions, tend to process student loans in their consumer loan departments mixed in with other installment loans. Given their volumes, this approach is probably the most sensible one.

- Small institutions, as well as thrift institutions, tend to perform student loan processing in their branches. Lacking automation, volume, and a "back office" processing tradition, "front office" servicing will likely remain for the foreseeable future.

In the light of these observations, the attitudes of lenders toward contracting out the servicing of their portfolios to student loan servicing firms is interesting—and unrelated to their size. When asked if they had seriously considered such an option, some lenders—generally in the person of the operations manager—indicated they had not because:

- They never contracted such work to an outside firm.

- Their state guarantee agency frowned on it.

- They had no confidence that an outsider could do it better or cheaper.

Other lenders, however, had investigated outside processing alternatives and found them attractive from the ongoing cost standpoint, but prohibitively expensive to convert existing accounts. Both large and small lenders were represented in both groups of respondents.

3.2.3 Credit Verification Practices

The verification of the past credit performance of student borrowers is not required by the GSL program as part of a regular—for other forms of consumer credit—evaluation of default risk. In the majority of cases, such an evaluation is meaningless for an 18- to 21-year old who has never been permanently employed. Nevertheless, two lenders surveyed to make regular use of credit reporting services (at a typical cost of $1.50 per inquiry) to check the credit records of student borrowers or their parents. Others said they had thought of doing so, but thought they

were not permitted to obtain such information. Some expressed an interest in making use of credit reports for older borrowers, particular veterans or older proprietary school students.

The lenders who follow this practice do so with full understanding that no credit check is required and that the guarantee program limits their exposure to credit losses. The practice is, in part, indicative of habit. In part, it also signifies an oft expressed reluctance by lenders to extend credit to "questionable" credit risks irrespective of guarantee coverage against losses.

3.2.4 ADP Approaches for Student Loans

As shown in Figure 3.1, of the 12 lending institutions surveyed, two are servicing student loans on a manual basis during both in-school and repayment periods. Both institutions are comparatively small. In two cases (one a relatively large participant), manual methods are used for in-school servicing; repayment servicing, along with the rest of the consumer loan portfolio, is performed on the banks' installment loan accounting systems. Most often—in six cases—student loans (both in-school and repayment) are processed as part of a regular accounting system, usually the personal loan accounting system. In one of these six, a commercial loan accounting system is being used because the institution found it most amenable to handle the no-principal amortization requirements during the in-school period. In only two cases has the lending institution developed a special purpose accounting system for student loans. One of the two has developed a time-shared computer system that goes beyond the capabilities of most installment loan systems.

Reflected in the pattern of systems approaches described above are certain efficiency losses incurred by banks in processing student loans:

- more costly manual processing rather than automated procedures;

  a "split" operation, one kind for in-school processing, another for repayment processing;

- inefficient use of manpower compared to that possible with a truly capable student loan system; and

- high data processing expense because of the "overhead" of an unsuitable commercial or personal loan system designed primarily for other purposes.

The fact that these penalties are being incurred is generally recognized by lenders. The ability to cost-justify more efficient and effective ADP systems for student loans is limited, however, because:

- While unit cost savings may be substantial, relatively low volumes limit the magnitude of the total savings potential.

- Systems development costs are perceived to be high.

As a result, lenders have tended to approach ADP for student loans in a manner similar to other low volume loan "products": avoid high startup costs, forego efficiency, and make do with a manual or compromised ADP system.

Personal loans are one of the least automated and, therefore, manually intensive operations in modern banking. As reported in the 1972 Functional Cost Analyses of over 900 banks by the Federal Reserve, personnel costs (salaries and fringes) account for almost 80 percent of the processing costs of installment loans. In comparison, personnel costs for demand deposit and time deposit operations account for only 50 percent to 60 percent of processing costs. The labor intensity of loan processing operations becomes apparent in examining the functions typically provided by automated data processing systems:

- maintenance of outstanding principal balance;

- maintenance of unearned discount;

- accounting for earned discounts for income reporting (or general ledger accounting) purposes;

- billing (unless payment books are used);

- allocation of payments to principal and interest;

- preparation of late notices; and

. late payment charge billing and accounting.

Virtually all of these functions are associated with booked loans that do not default. Minimal ADP support, if any, is associated with loan acquisition and collection activities.

Given the low level of personal loan automation and the high proportion of personnel costs, it might be argued that lenders with non-existent, inefficient, or inappropriate ADP systems for student loans should suffer little if any penalty in either the personnel component of operating costs or operating cost in total. It is difficult to reconcile such an assertion with the facts reported by the survey:

- The lenders with specialized student loan systems reported the lowest operating cost.
- The lenders with split manual/mixed personnel loan systems or an admittedly unsuitable commercial loan system reported the highest operating cost.
- Though comparisons are difficult for a number of reasons, the servicing firms surveyed are also at the low end of the reported cost range. All have systems designed specifically for student loans.

From the systems design standpoint, the following characteristics of student loans are important:

- Most students (50-75 percent) are multiple borrowers with the same institutions. It is important, therefore, that an accounting system be able to cross reference or integrate multiple loans for a single borrower. Few personal loan accounting systems provide such a capability.
- Principal is not amortized and terms are not fixed during the school period and interest is almost always paid by the government. Virtually all installment loan systems are built around the concept of principal amortization during a fixed term with all payments made by the borrower.

3.3 Operating Costs

Operating cost data were most consistently available from surveyed institutions expressed as a percentage of outstandings. Costs expressed on this basis are relevant to an economic or profitability analysis of lending operations. Such data provide little insight to the operations in which costs are being incurred either per unit of activity (per new loan added, per payment received, etc.) or for a volume of activity. Servicing activity, not dollars outstanding, is the prime determinant of processing cost. Therefore, costs on such a basis are not useful for evaluating the potential economic effect of specific changes to the program that might permit savings to be realized.

Nonetheless, operating costs as a percentage of outstandings were needed to support the analysis of alternative special rate allowance indices discussed in the prior chapter. Besides, in conjunction with some understanding of the practices of lending institutions, one can draw certain useful conclusions from cost-versus-outstandings data.

Figure 3.2 shows operating costs for 10 institutions as a percentage of outstanding loan amounts. Eight of the institutions (A through H) are lenders; two (J and N) are fees for loan servicing firms. To the extent possible, all student loan operating costs (the open bars) exclude branch operating expense and, therefore, a certain amount of loan acquisition cost. Since the ten surveyed lenders have centralized operations with low-to-medium levels of branch involvement, the exclusion should permit save comparisons. Where available, comparable cost data for other consumer loans (the single-hatched bars) are also shown on Figure 3.2 for the surveyed institutions. Bad debt costs (the cross-hatched bars) for consumer loans are also shown, where available. For operating cost comparison, they can be excluded. Also for comparative purposes, consumer loan operating costs are shown as reported by the Federal Reserve in their Unit Cost Analysis for 1972, adjusted as shown in Figure 3.3.

For purposes of the discussion that follows, it should be noted that comparison of lender costs--aside from the limited number of institutions represented--is often difficult:

> Many lenders do not know what their operating costs are for student (and/or other) loans. Certain figures reported, therefore, are somewhat suspect.

Figure 3.2

OPERATING COST AS A PERCENTAGE OF OUTSTANDINGS

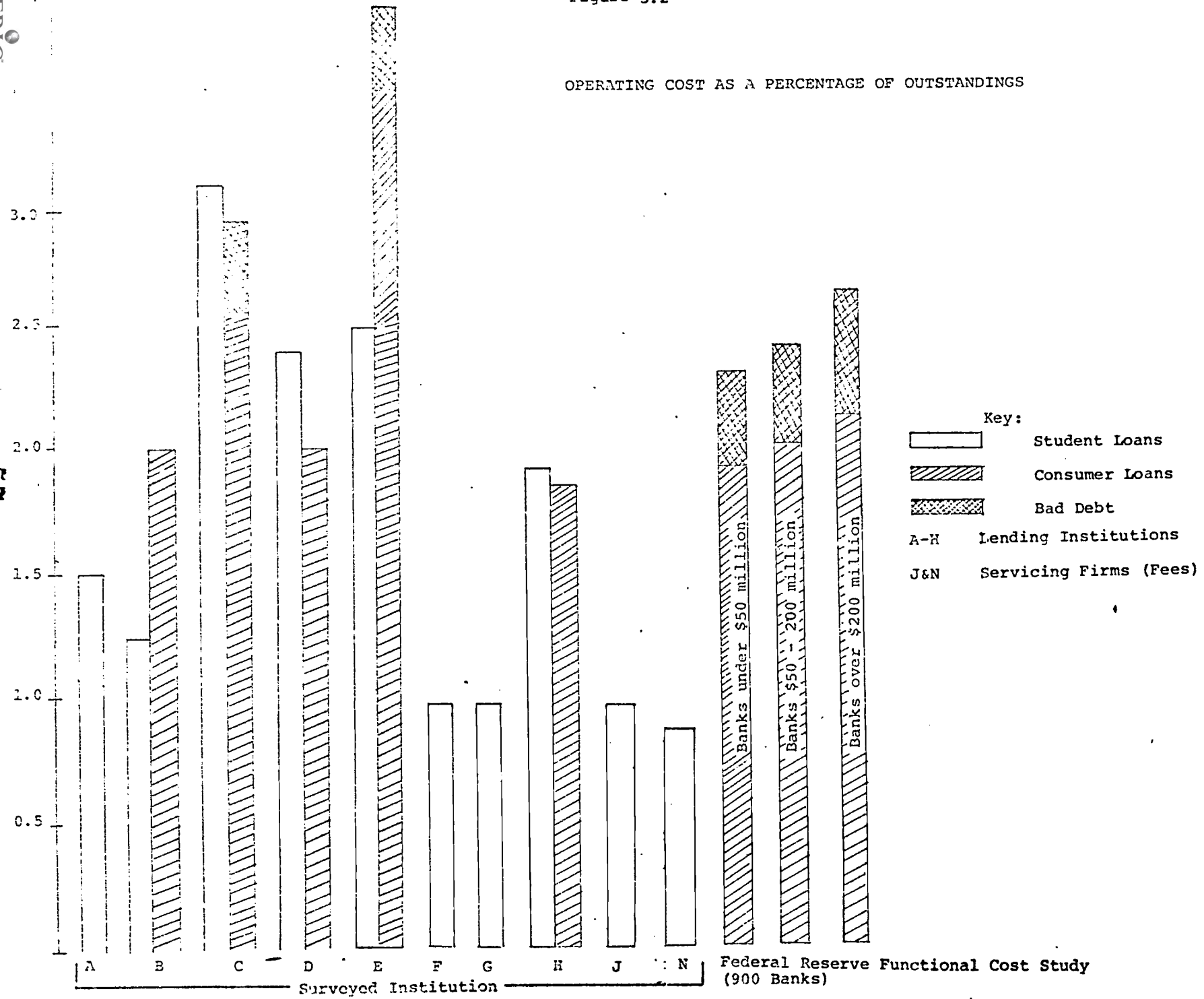


Figure 3.3

ADJUSTMENTS TO GROSS
INSTALLMENT LOAN OPERATING COST AS PERCENT OF OUTSTANDINGS

	Bank Size		
	Under $50 Mil.	$50-200 Mill.	Over $200 Mil.
Gross Cost	3.2%	3.3%	3.4%
Less - Branch Expense	1.0%	1.0%	1.0%
Publicity & Advertising	0.2%	0.2%	0.1%
Creditor Life Inusrance	0.1%	0.1%	0.1%
Subtotal	1.3%	1.3%	1.2%
Net Cost	1.9%	2.0%	2.2%
Plus - Loan Losses	.4%	.4%	.4%
Total Operating Cost	2.3%	2.4%	2.6%

- Lenders with documented costs use different bases: total period costs, department period costs, departmental unit costs, functional unit costs. A certain amount of analytical judgment was required to state all costs on a consistent basis, where data were available to permit doing so.

- Lenders include (or omit) branch-incurred costs, institutional overhead, and advertising expense. All attempts were made, given the understanding of the persons interviewed, to ensure that such items were consistently excluded.

- Lenders subscribe to different practices for:

    - interviewing students and parents;

    - credit checking; and

    - operations and systems.

  Such practices are, to a large degree, discretionary and reflect management philosophy and attitudes rather than the specific requirements of student loan processing.

- The cost structure of servicing firms can be quite different from certain lending institutions in certain significant respects. Space charges can often be much lower outside of a space-inefficient branch or a downtown business district. Personnel compensation patterns and use of part-time personnel can also be substantially different from bank practices. Where servicing firms may have broad latitude in such areas, lenders may have little.

Given those caveats, and with the understanding of operating approaches as discussed in Section 3.2, it is possible to make certain general conclusions about cost:

- Efficient lenders can achieve cost levels approaching that of servicing firms. Lenders that centralize and specialize student loan operations and develop efficient, specialized student loan systems are more likely to do so.

- Higher costs tend to be associated with branch processing, manual operations, or unsuitable systems.

- Lenders can operate their student loan portfolios at costs comparable to other consumer loans—either their own or the FED reported consumer loan average.

- In comparison to consumer loans, student loan account maintenance costs are lower; acquisition costs are higher.

It should be emphasized that these observations have been made for institutions that largely avoid a heavy degree of branch processing, particularly during the acquisition cycle. Student loan acquisition, as will be seen later, is a relatively complicated, time-consuming, and costly process. When performed in a branch, as it most often tends to be in a small commercial bank or thrift institution, its cost penalties—and visibility to management—become magnified. In a branch environment, the low volumes involved rarely, if ever, consume incremental resources—personnel or facilities that, in the absence of student loans, could be eliminated.

The costs of servicing student loans compared to consumer loans are not uniformly higher for all activities. During repayment, monthly servicing costs for student loans are virtually identical to consumer loans. For those lenders that service student loans with personnel and systems shared with consumer loans, periodic processing requirements are virtually indistinguishable between them. During the in-school period, as shown in Figure 3.4, monthly servicing costs for student loans are about 50 percent lower than for consumer loans because:

- Individual loan payments are not being received.

- Interest is being billed to the U.S. Government, in bulk, on a quarterly basis.

Forty to sixty percent of the surveyed institutions' portfolios were in in-school status.

In examining the acquisition costs for student loans compared to consumer loans, the comparison is far from feasible. Lenders surveyed uniformly reported that student loan acquisition costs were "substantially" higher than

Figure 3.4

MONTHLY OPERATING COST—IN-SCHOOL PERIOD

	Repayment Student Loans*/ Consumer Loans	In-School Student Loans	Percent of Personal Loan Cost
J*	$1.46	$.85	58%
I*	.75	.40	53%
M	.65	.40	62%
N*	1.25	.45	36%
G	N/A	.20	N/A
H	1.00	.30	33%
Average (Excluding G)	1.02	.48	47%

*Student Loan Servicers

costs for consumer loans. Figure 3.5 contains unit acquisition costs—the cost of processing each student loan from first interview to disbursement and account entry on the "books"—for:

- origination—the loan instrument that remains open during the in-school period; and
- repayment—the loan instrument that covers the student's obligation during repayment.

The extremes of unit costs reported are rather substantial. The highest reported cost—$200 per loan—is hardly typical; it was supplied by a big-city bank that performs much acquisition processing in its branches. Although the amount appears suspect, the magnitude—and the 400 percent reported premium over consumer loan cost—is not unlike the experience of its competition in the same city. At the other extreme, the $12.50 cost per unit reported by another bank has been conceded to suffer from unrealistically low personnel and facilities cost estimates. Excluding these extremes, the most important and consistent finding is that:

- Acquisition costs for student loans are demonstrably higher than consumer loans.
- Such costs are easily one-and-a-half to three times that of consumer loans.

It appeared evident from the survey that the unit cost penalty for student loan acquisition is higher than that for any other activity unique to the student loan program. From the standpoint of lender attitudes, it is unfortunate that such a large cost penalty should exist in that part of the cycle that is most visible to management, particularly where branch involvement is high. Irrespective of cost, the procedural requirements of student loan acquisition raise lender ire for perceived nuisance value alone.

There are, to be sure, substantive reasons why student loan acquisition cost should, in fact, be higher than for consumer loans:

- More interviewing is needed, sometimes involving the parents, to explain the nature and, often complexities of the program to a student embarking on his or her first lending experience.

Figure 3.5

COST OF ACQUISITION—ORIGINAL AND REPAYMENT

	Amount	Percent of Consumer Loan Cost
J	$ 21.30	N/A
K	$200.00	400%
L	$ 81.00	300%
G	$ 12.50	N/A
C	$ 26.28	300%
M	$ 28.66*	150%
H	$ 19.93	160%

*May not include repayment acquisition.

- There are two "acquisitions" for each loan. The first occurs for the student to obtain the borrowed funds. The second occurs, at the beginning of repayment, for the bank to recover the funds lent. Although the "conversion" of an in-school loan to a repayment loan is much less complicated, a significant amount of work is required (one bank estimates one-third the effort associated with origination).

- The origination cycle is complicated. As depicted in Figure 3.6, it involves: three parties, besides the student (and, perhaps, his or her parents); six or more forms, not counting the disbursement check and the lender manifest; at least three accesses (assuming no errors are made) to the student's in-process loan file. The avoidance of certain activities (e.g., credit verification) associated with consumer loans that are not performed for student loans do not offset the student loan differences.

3.4 Possible Changes to GSL Operations

During the course of discussions held with GSL lenders and servicing firms, a number of suggestions were either offered or confirmed as desirable when offered for consideration. These possible changes to GSL operations fall into two general categories:

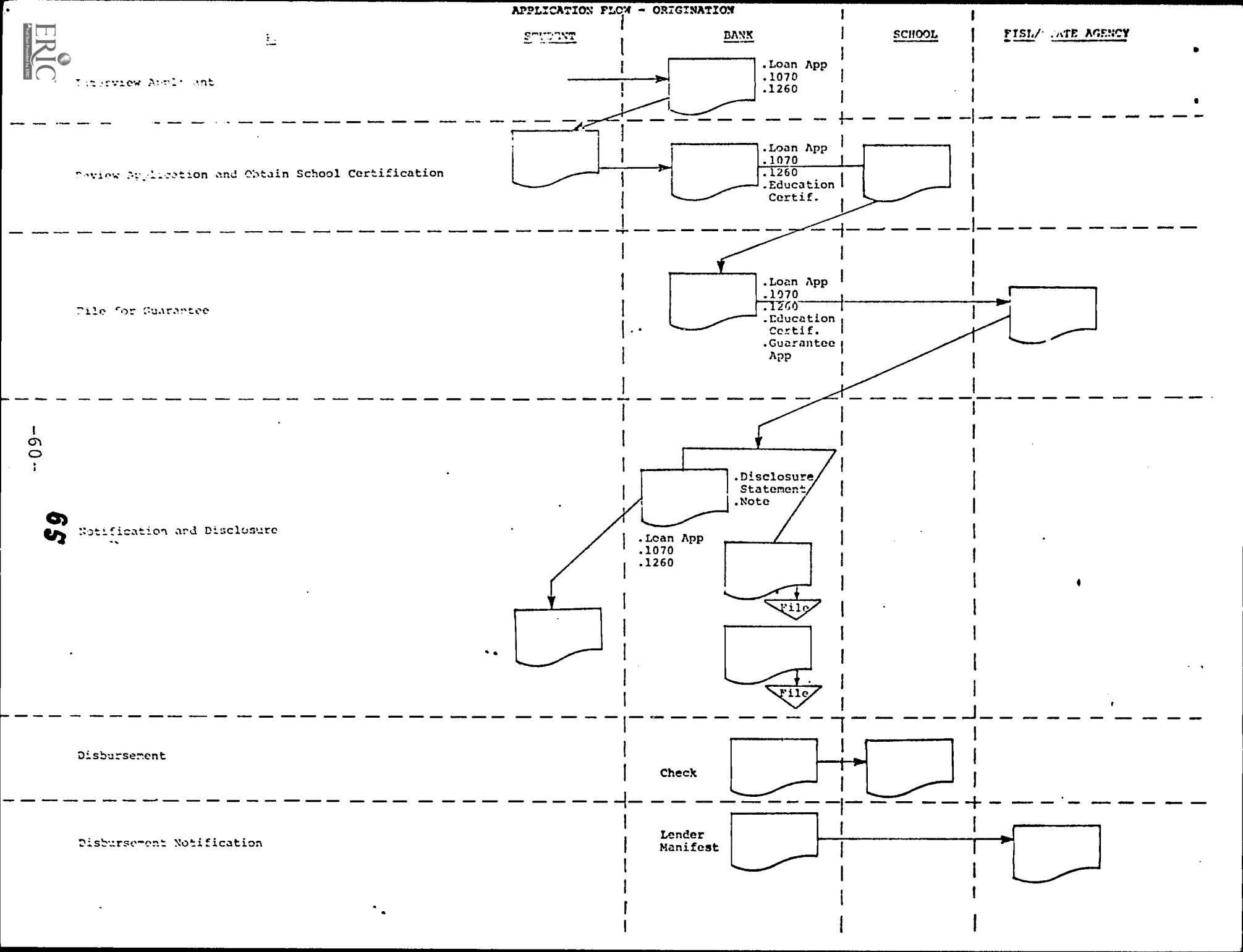
- modifications to operating requirements of the program; and

- changes of a management nature.

Many of these suggestions have been made before. They are mentioned here because of the extent of their appeal among the surveyed institutions.

There were five major suggestions offered for modifications to student loan operating requirements:

- multiple purpose forms for loan origination, consolidating on a single form the (often redundant) information now required on several forms.


APPLICATION FLOW - ORIGINATION
STUDENT
BANK
SCHOOL
FISL/ ATE AGENCY
Interview Applicant
.Loan App
.1070
.1260
Review Application and Obtain School Certification
.Loan App
.1070
.1260
.Education Certif.
File for Guarantee
.Loan App
.1070
.1260
.Education Certif.
.Guarantee App
Notification and Disclosure
.Disclosure Statement
.Note
.Loan App
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.1260
File
File
Disbursement
Check
Disbursement Notification
Lender Manifest

- elimination of guarantee filing before disbursement in favor (as is the case for FHA Title I loans) of filing after-the-fact. The larger institutions expressed the opinion that they were confident enough in their lending judgment to undertake such a change and take the risk themselves in any loans disbursed and subsequently rejected for the guarantee.

- a "streamlined" acquisition cycle for repeat borrowers at the same institution. Lenders reported that 50 to 75 percent of current applicants are repeat borrowers, many for the third and fourth time. Despite their familiarity with the borrower, lenders go through the same, complicated acquisition cycle every time the borrower appears for a new loan.

- provide for payment of the insurance fee coincident with the submission of the lender manifest. Subsequent remittance, as at present, necessitates additional processing and payment reconcilement.

- eliminate separate accountability requirement for each disbursement. At present, each disbursement has to be treated as a separate loan for account and reporting purposes. Multiple loan records must be maintained for the majority of borrowers. Accounting and reporting would be simplified if the obligations of each borrower could be carried as to a single, outstanding total.

All of these changes would reduce the cost—and perceived frustration—incurred by lenders participating in the student loan program.

Other changes in the management of the program were also suggested by lenders:

- Apply all changes in the legal, operating, procedural, or documentary requirements of the program retroactively to loans outstanding from prior years. Program distinction between loans granted during different years proliferates the requirements that must be met by lenders.

- Announce program changes well before the peak processing session for new loans. Program changes, it is alleged, are invariably announced in July and August, as the peak lending season is underway. Lenders find it particularly difficult to integrate revised program requirements into their operations during this high volume period.

- Make claims payments or defaulted loans faster and/or pay interest until such payments are made. FISL lenders, in particular, complained about foregoing interest during long (9- to 12-month) claims settlement cycles. Lenders participating in state programs reported much shorter and consistent cycles. Since many are paid interest until settlement, state program participants are less concerned with the problem.

- Have the U.S. Government take a more aggressive and visible role in collection of delinquent and defaulted accounts. Lenders' concern about student loan defaults is out of all proportion to their financial losses. Lenders expressed a fundamental aversion to a level of defaulted GSL obligations. substantially higher than their other consumer loan experience. Lenders believe that active government participation in collection will significantly reduce defaults among a mobile population with "non-traditional" attitudes toward borrower obligations to repay.

3.5 "Trial Balloons"

As requested by the Office of Education, lenders and servicing firms were asked for their views about:

- direct interest collection from the student during the in-school period versus interest deferral during the in-school period; and

- use of a form of revolving credit as a borrowing vehicle for students rather than the present multiplicity of installment loans.

In the former case, direct collection versus deferral for in-school interest payments were offered as an "either-or" alternative to quarterly billing of student interest to the government. Direct collection from the student was almost universally disliked. Difficulties in handling delinquent payments, small transaction amounts and high volumes were often cited as negative aspects of direct interest billing. Most state participants had direct, in-school billing experience and didn't like it. The degree of dislike was often expressed as a "last straw" for opting out of the student loan program. As a forced choice alternative, lenders preferred to defer student interest during the in-school period. Few had any problems in foregoing the cash flow. Some, however, indicated that deferral would be acceptable only if interest were compounded and accumulated on the deferred interest.

The latter concept tested was the use of a form of revolving credit as a borrowing vehicle for students. Revolving credit, including overdraft checking and bank credit cards, is rapidly displacing installment loans in consumer lending relationships. From the lender standpoint, revolving credit instruments offer substantial operating savings, especially compared to the typical succession of installment loans. The features of a form of revolving credit for student borrowers are outlined in Figure 3.7. Its potential suitability for student lending relationships is particularly suggested by:

- the high incidence (50 to 75 percent) of multiple loans, each requiring a costly acquisition process—twice (origination and repayment); and

- funds needs that often are spread out over a school year. In many cases, student borrowers do not need a single large disbursement (e.g., for tuition) but rather a succession of smaller amounts for living expenses. Since few institutions will make more than one disbursement per year (because a costly acquisition effort must be undertaken for each one), the student must take borrowed funds before they are needed with the government paying an additional interest cost.

Figure 3.7

FEATURES OF REVOLVING CHARGE

- One-time acquisition/commitment entering school.
- Initial "line" amount for first year disbursement.
- Student receives check-like drafts made out to him/her and school (perhaps with "plastic").
- Student draws against line as funds are needed.
- Disbursements accumulated into single outstanding balance.
- Simple interest computed on average outstanding.
- Principal repayment credited as paid.
- Line amount adjusted each year upon certification of enrollment.

The vast majority of lenders saw merit in the concept, subject to a suitable resolution of operating details.